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INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY
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C O N F I D E N T I A L SECTION 01 OF 03 LONDON 001451

NOFORN
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E.O. 12958: DECL: 06/19/2019
TAGS: EFIN ECON UK
SUBJECT: LONDON-BASED EXPERTS AGREE THE U.S. DOLLAR WILL
MAINTAIN ITS RESERVE STATUS

REF: LONDON 1399

¶1. (C/NF) SUMMARY: Despite the decline in the dollar share of global FX reserves over the past decade and recent debates on the creation of a new global reserve currency, the U.S. dollar's reserve status remains in-tact. Gains made by its nearest rivals--the euro, pound sterling, and yen--over the same period have not come at the expense of the dollar. Currency experts at HSBC and Deutsche Bank stressed to ECONOFFs during recent meetings the dollar's principal reserve position took time to build up and would require a long time to change. They agreed recent proposals to make the SDR a global reserve currency lacked viability. The dollar's trend decline, coupled with smaller developed currencies as well as emerging market currencies gaining importance, suggested greater diversification in terms of currency composition of central bank holdings instead of full displacement of the dollar. Longer term, an economic order based on a multiple reserve currency system is a possibility. End Summary.

Consensus on Dollar Maintaining Reserve Currency Status

¶2. (C/NF) Along with other London-based financial experts (reftel London 1399), senior currency strategists agree the replacement of the dollar as the global reserve currency is unlikely. During meetings on June 16 with ECONOFFs, both David Bloom of HSBC and Henrik Gullberg of Deutsche Bank cited that IMF data on FX reserves indicated the dollar maintained a significant share of world reserves by a large margin from 2001 to 2008 and noted, more importantly, the data captured changes in FX reserve composition by central banks during a period of intense financial market volatility and when some central banks intervened to support their domestic currencies. Both FX experts maintained the dollar's nearest rivals--the euro, pound sterling, and yen--failed to gain significant ground over the same period. The dollar share of total holdings of FX reserves fell from 71.5 percent in 2001 to 64 percent in the final quarter of 2008 but still accounted for more than twice the euro holdings, sixteen times more than pound sterling holdings, and twenty times more than yen holdings. Put simply, Bloom told us, the decision to hold a reserve currency is a very political decision; central banks consider the economic and political influence of a country and also its political and default risks. At the end of the day, Bloom said, people still want their long-term investments, such as pension funds, invested in dollars because the U.S. provides the safest investment. Gullberg noted Bank of Qternational Settlements (BIS) data on FX turnover, albeit lagged, revealed some smaller developed currencies--Australian and New Zealand dollar and the Swedish krona--as well as some emerging currencies--the Hong Kong dollar and Polish Zloty, for example--have

increased in importance, though from a low level. Given currencies, rankings as official reserves typically parallel their status in international trade, this development might mean official reserves also will become more diversified says Gullberg; but it does not suggest displacement of the dollar.

¶3. (C/NF) In their May 2009 Currency Outlook, HSBC analysts argue even if the world continues to switch from the dollar to the euro at the rate of one percent per year, it would take 30 years for the two currencies to be held in equal proportions. For the euro or one of the dollar's nearest rivals to overtake the it as the main reserve currency, a significant number of changes would need to take place; in particular, there would have to be some material loss of confidence in the dollar as a store of value and a loss of confidence in the U.S. economy. Gullberg also stressed to us the euro was still a "fresh experiment" and problems in peripheral euro-area countries may drag it down.

¶4. (C/NF) Gullberg told us the longer term risk to the dollar's reserve status is inflation--more specifically if the U.S. faces sustained high inflation relative to other major economies, market and trade participants might be tempted to use another store of value. However, he stressed there has been no real evidence of inflation risk. Recent talk about exit strategies suggest the Federal Reserve and other central banks are aware of the longer-term inflationary consequences of running an expansionary policy for too long.

Special Drawing Right (SDR) Proposals Lack Credibility
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¶5. (C/NF) During the meeting with ECONOFFs, Bloom called discussions of the SDR as a reserve currency fanciful. He argued while some G20 members have raised the idea of replacing the dollar with the SDR, actual implementation would be incredibly complicated and therefore, he attached extremely low probability to the switch. He viewed the recent SDR proposals as political posturing rather than financial reality. In practical terms, it is difficult to suddenly and dramatically change the status quo of reserve ownership, he said. Gullberg also questioned the credibility of discussions of changing the SDR basket. He asserted a basket which included the Russian ruble and Chinese yuan would add to appreciation pressure, at the margin, on their own currencies because countries would be accumulating each others' currency. Currently the SDR's exchange rate is determined by a basket of currencies that include the dollar, yen, and pound sterling. The IMF is expected to review the basket in November 2010. (Comment: According to press reports, President Dmitry Medvedev recently urged the IMF to expand the currency basket of SDRs to include the Chinese yuan, commodity currencies, and gold as part of the process of the SDR maturing into a reserve currency.)

¶6. (C/NF) If the SDR became the world's reserve currency, the composition of reserves would have to change materially says Bloom. Using the current dollar share as a starting point, HSBC analysts in their May 2009 currency outlook, posit shifting the 64 percent to an SDR proportion of dollars at the current exchange rate would mean central banks would have to cut the weight of the dollar by 22 percent, i.e. sell roughly 1.5 trillion dollars, assuming central banks hold 4.3 trillion of dollars in reserves now. (Comment: The SDR is comprised of fixed currency amounts, not fixed currency weights and the currency weights change on a daily basis because the value of the currencies within the SDR change. The IMF reviews the currency amounts every five years.) The sale would be made up by the ownership of the euro, yen, and pound sterling. As the fixed dollar amounts remain unchanged in the SDR, one would have to sell more dollars as the dollar fell in value. If the shift to the SDR precipitated a 20 percent drop in the dollar's value, the amount of dollars sold would have to rise to $2.5 trillion because of the

falling weight of the dollar in the SDR as the dollar depreciates. Using this example, analysts argue the reality of a shift away from the U.S. dollar is implausible.

Jawboning by Russian officials?

¶7. (C/NF) Timothy Ash, Head of CEEMEA Research at the Royal Bank of Scotland, commented about mixed signals from policymakers in Russia on Moscow's developing alternative reserve currencies in his June 16 report. He maintained Russian officials had been pushing for alternatives to the dollar as the global reserve currency for months, in part to use the global financial crisis as a means to further challenge the U.S. global hegemony since the collapse of the Soviet Union in the early 1990s. Recent comments by Russian Finance Minister Kudrin suggesting the dollar's dominance as the global reserve currency would remain for some time and the dollar's fundamentals were still "fine" potentially implied a change of tack from Moscow. However, Ash argued Russian President Medvedev and Senior economic advisor Arkady Dvorkovich appeared to distance themselves from Kudrin,s remarks and suggested the long-term goal was still to diversify the range of global reserve currencies. Ash contends the jawboning by Russian officials has refocused market and broader political attention on the BRIC summit and underscored Russian and BRIC influence over bigger picture dollar trends. Russia's mission remains to push forward alternatives to the majors as reserve currencies.

World of Multiple Reserve Currencies A Possibility, Down the Road
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¶8. (C/NF) While the SDR proposal may seem implausible, Bloom sees the potential in the distant future, with open markets, of a multiple reserve currency system with the dollar, euro and Chinese yuan sharing reserve currency status. There would naturally be winners and losers in such a system with the single reserve currency losing some status relative to the new entrants but it would not imply full displacement of the previous single reserve currency (i.e. the U.S. dollar). Bloom likened the debate to the one on which would become a bigger financial center--Hong Kong or Singapore. He argued history has proven there is room for both; therefore a world

with multiple reserve currencies is possible if critical mass in markets creates the environment. Gullberg, however, argues a multiple reserve currency scheme takes away the benefit of having a reserve currency in the first place. Professor Danny Quah of the London School of Economics suggested to us during a June 16 meeting that China may not be ready to have the yuan serve as an international reserve currency and highlighted the concerns about China's currency appreciating too quickly. Despite talk about boosting domestic demand, China remains an export-led economy; a rapid appreciation would lead to a loss in export competitiveness. As a holder of $700 billion of U.S. debt, rapid appreciation would yield 25 percent loss in real wealth.

Mixed Views on Chinese Efforts to Promote Yuan Internationalization
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¶9. (C/NF) Experts are divided on the effectiveness of Chinese efforts to promote the use of the yuan internationally. Professor Quah posited recent efforts to promote yuan use regionally were a good "testing the water" step for greater international usage. China's trade with East and Southeast Asia is double that with the West so settling transactions in the yuan may help relieve pressure within the region. Gullberg, on the other hand, calls Chinese efforts to use the yuan in trade unrealistic and was not confident its trade partners would sign on to conduct transactions in it. HSBC analysts, in their May 2009 outlook, noted widespread take up

of the option to settle in yuan would depend on the specifics of the policy. Pent-up demand among Hong Kong firms whose main business is centered on the mainland should give the scheme some critical mass at early stages. Firms conducting international trade are likely to be more worried about the risk management flexibility that comes with the currency denomination; consequently, the regulations will need to offer some reasonable degree of yuan convertibility to make it sustainably attractive.

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